

FIRST MONETARY POLICY REPORT
FOR 1982

FROM THE
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS

UNITED STATES SENATE
NINETY-SEVENTH CONGRESS

SECOND SESSION

A REPORT

together with

ADDITIONAL VIEWS

SUBMITTED PURSUANT TO PUBLIC LAW 95-523



MAY 5 (legislative day, APRIL 13), 1982.—Ordered to be printed

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(II)

LETTER OF TRANSMITTAL

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C., May 5, 1982.

HON. GEORGE BUSH,
President of the U.S. Senate,
Washington, D.C.

DEAR MR. PRESIDENT: Transmitted herewith is the First Monetary Policy Report for 1982 on the Conduct of Monetary Policy, pursuant to Public Law 95-523 and oversight hearings held on February 11 and 25, 1982.

Sincerely yours,

JAKE GARN, *Chairman.*

(III)

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FIRST MONETARY POLICY REPORT FOR 1982

MAY 5 (legislative day, APRIL 13), 1982.—Ordered to be printed

Mr. GARN, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT together with ADDITIONAL VIEWS

On February 10, 1982, the Committee on Banking, Housing, and Urban Affairs received this year's first "Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978" (Public Law 95-523) from the Board of Governors of the Federal Reserve System.

Two days of hearings on the Report and monetary policy were held by the Committee. On February 11, 1982, Federal Reserve Board Chairman, Paul A. Volcker presented a statement and testimony to the Committee. On February 25, 1982, statements and testimony were received from Beryl Sprinkel, Department of the Treasury, Under Secretary for Monetary Affairs; Jerry L. Jordan, Member, the President's Council of Economic Advisers; George W. McKinney, Jr., Senior Vice President, Irving Trust Company; Henry Schechter, Director, Office of Monetary Policy, AFL-CIO; and Michael Sumichrast, Chief Economist, National Association of Home Builders.

MONETARY AGGREGATES

Focusing on growth in the M1-B monetary aggregate as measured by comparing fourth quarter averages in 1980 and 1981, Secretary Sprinkel praised the Federal Reserve's overall success last year in slowing the rate of monetary expansion:

Every journey must begin with the first step and the Federal Reserve took that step in 1981, holding the rate of money growth to 5 percent.

Sprinkel contrasted this with " * * * the excessive 8 percent growth of recent years * * *" and the steadily rising trend of monetary growth since 1965.

TABLE I

Years	Annual rate of change in M ₁ (percent)
1965-70	5.0
1970-75	6.1
1975-80	7.1

At the same time, both Secretary Sprinkel and Mr. Jordan criticized the extent of month-to-month volatility in money growth over the course of last year. In particular, Mr. Jordan pointed out that "From October (of 1981) to January (of 1982) * * * the narrow measure of money (M1) expanded at a 15 percent annual rate." Mr. McKinney, on the other hand, praised the Federal Reserve "for not trying to fine-tune money growth" last fall.

Volatility

As a way to reduce money-growth volatility, Secretary Sprinkel suggested an end to the very practice of attempting to control any of the definitions of the "money supply." With no direct control over these aggregates, the Federal Reserve today resorts to attempting to use the control it does have over the monetary base (bank reserves plus currency in circulation) to influence changes in the money supply.

According to Secretary Sprinkel, with the focus on the money supply, a fluctuation in it which the Federal Reserve does not recognize to be "random and self-correcting" will cause the Fed to make a destabilizing adjustment to the monetary base. To avoid this source of money-supply volatility, the Secretary recommended that the Federal Reserve begin targeting and attempting to control the monetary base directly rather than the money supply.

Secretary Sprinkel also told the Committee that, to further "improve the precision of the Federal Reserve's policy actions" " * * * the Federal Reserve should eliminate lagged reserve requirements and tie the discount rate to a market interest rate * * * "

Again pointing to the "great ripples in the stock market and the money markets" caused by the Federal Reserve's current practice of announcing meaningless weekly changes in the seasonally-adjusted M1 monetary aggregate, Chairman Garn prodded the Federal Reserve to pursue proposals for changing the current system of announcing M1 estimates. In this regard, Chairman Volcker noted that " * * * a weekly seasonal (adjustment) is almost impossible to compute in a reliable way."

Like Secretary Sprinkel, Mr. McKinney also suggested an end to focussing on control of money supply growth, but for a different reason:

In the long run, the Federal Reserve and the Congress should try very hard to find some way to break away from rigid money targeting. Markets have become so sensitized to money growth data that random swings and seasonal aberrations elicit exaggerated, destabilizing reactions. It would be far better to target nominal GNP, total credit, or perhaps some other broad objective.

TARGETS

The overall fourth-quarter to fourth-quarter growth in M1-B during 1981 was somewhat below the Federal Reserve's target range for growth in the aggregate. The broader aggregates, however, grew at rates near to—or above—the upper boundaries of their target ranges.

Table II summarizes the 1981 growth rate in the targeted aggregates.

TABLE II.—1981 MONETARY GROWTH RATES

[In percent]

Aggregate	1981 actual ¹	1981 target	Target midpoint	Actual minus target midpoint
M1A shift adjusted.....	1.3	3.0-5.5	4.25	-2.95
M1B shift adjusted.....	2.3	2.5-6.0	4.75	-2.45
M1B.....	5.0	6.0-8.5	7.25	-2.25
M2.....	9.4	6.0-9.0	7.50	1.90
M3.....	11.4	6.5-9.5	8.00	3.40
Bank credit.....	28.8	6.0-9.0	7.50	1.30

¹ 4th quarter to 4th quarter.

² December level used for calculating this 1981 growth rate incorporates an adjustment to abstract from the shifting of assets from domestic banking offices to international banking facilities.

The Federal Reserve Report ascribed the differential in growth rates between the narrow and broader aggregates to businesses' and individuals' economizing on cash balances (the major component of M1-B) and putting more of their funds into investments like money market mutual funds yielding market rates of interest (assets included in the broader aggregates but not in M1-B):

* * * the growth of the narrow aggregates * * * was low in 1981 compared with the other aggregates and also relative to past relationships with income and interest rates. Continued high interest rates provided a substantial incentive for businesses to intensify efforts to pare narrow money balances and to make increasingly widespread use of sophisticated cash management techniques. At the same time, explosive growth of money market mutual funds (MMMFs), many of which offer check-writing or other third party payment services comparable to conventional checking accounts, appeared to induce some households to minimize checking account balances.

As other factors causing discrepancies among the growth rates of the various aggregates, Chairman Volcker also pointed to "changes in the composition of commercial bank financing patterns toward domestic sources" and "institutional change" such as the relaxation of interest rate ceilings applicable to time deposits.

1982 Targets

As noted in the Second Monetary Policy Report for 1981, last July the Federal Reserve tentatively announced that for 1982 only one M1 aggregate would be published and targeted, equivalent in coverage to 1981's M1-B (not shift-adjusted); that the tentative target range for growth in this aggregate would be 2.5 to 5.5 percent; and that the tentative target ranges for the other monetary aggregates would be un-

changed in 1982. In his February 11 appearance before the Committee, Chairman Volcker reported the Federal Reserve's decision to adopt these tentative decisions, including the modest lowering of the M1 target range.

Secretary Sprinkel reported that:

The Administration supports completely the stated policy of slowing the average rate of money growth and we believe that the announced (M-1) target of 2.5-5.5 percent for 1982 is appropriate. However, * * *, we recommend monetary expansion in the upper one-third of the range."

Concurring, Chairman Volcker stated that:

Given the present level of M1 and the relatively slow growth last year, the FOMC at this time feels that an outcome in the upper half of the range would be acceptable, and that M1 could acceptably remain somewhat above the implied "growth track" during the period immediately ahead.

Also agreeing was Mr. Jordan:

I firmly believe that if money growth promptly is reduced to the announced target ranges, and a rate of increases in the 4 to 5 percent range is maintained on balance through the remainder of 1982, interest rates will decline, growth of output and employment will increase, while inflation will continue to decline.

Disagreeing was Mr. Sumichrast who argued that higher target growth ranges for the monetary aggregates are needed if interest rates are to be lowered sufficiently.

ECONOMIC DEVELOPMENTS

Inflation

During 1981 inflation slowed substantially. As noted by Chairman Volcker:

* * * there are now signs of real progress on the inflation front. That progress is reflected to greater or lesser degree in all the widely used inflation indices. Consumer prices rose 8.9 percent last year, 3½ percentage points less than the 1980 peak, and the inflation rate seemed to be trending lower still as the year ended. Finished goods producer prices have had an average increase at an annual rate of only about 4 percent for six months.

Secretary Sprinkel presented evidence that the accelerating inflation up to last year was a direct result of accelerating money growth over the fifteen preceding years.

TABLE III

Years	Annual rates of change (percent)	
	M ₁	GNP deflator
1965-70.....	5.0	4.2
1970-75.....	6.1	6.5
1975-80.....	7.1	7.2

The Federal Reserve Report emphasized the sectoral aspects of the decline in inflation:

Important factors in the slowing of inflation were exceptionally favorable agricultural supplies and declines, after the first quarter, in world oil prices. Inflation in areas other than food and energy—particularly consumer commodities and capital equipment—also began to abate, although price pressures persisted in the consumer service sector, notably for medical care.

Output and employment

Again taking a longer-term perspective, just as Secretary Sprinkel showed the correlation between inflation and money growth, so too did he illustrate a similar correlation over the last fifteen years between rising levels of unemployment and rising levels of inflation and money growth.

TABLE IV

Years	Annual rate of change (percent)		
	M ₁	GNP deflator	Average unemployment rate
1965-70	5.0	4.2	3.9
1970-75	6.1	6.5	6.1
1975-80	7.1	7.2	6.8

Still, the extent of the decline in output (down at an annual rate of 4.5 percent in the fourth quarter after growing at a 1.4 percent rate in the third) and the extent of the increase in unemployment (8.8 percent in December) last year were attributable to a recession caused by the end of the fifteen year trend of steadily rising money growth.

Secretary Sprinkel noted:

The slowing in money growth was abrupt and substantial, exceeding both the expectations of the Administration and the targets of the Federal Reserve. Given the prevailing trends, it was inevitable that such a sudden shift in money growth would have a significant depressive effect on real economic activity.

And as he also noted:

* * * the restriction of output and employment (was) the inevitable payment for past monetary excesses.

As already pointed out, the Federal Reserve Report argued that the slowing growth in M1 last year was, at least in part, a response to the financial innovation of money market mutual funds. But by definition, for such a financial innovation to justify changing the growth target for M-1, it must alter velocity.

With respect to inflation and real growth in combination (i.e. "nominal income"), Secretary Sprinkel observed that, "Growth of nominal income continues to be related closely to the pattern of growth of M1." Similarly, Mr. Sprinkel told the Committee that:

* * * changes in velocity do not appear to be any more volatile than they have in the past. Indeed, changes in the

trend of the growth rate of nominal GNP over the period 1960 to 1981 are almost entirely attributable to changes in the trend of the growth rate of the money stock (M1), as opposed to changes in the trend of the growth rate of velocity.

The import of the comments made by Secretary Sprinkel and Mr. Jordan on the continuing close correlation between M1 and nominal income is that they do not believe that financial innovations have sufficiently impacted velocity so as to justify changes in the M1 target. A corollary is that they do not believe that financial innovations have sufficiently impacted M1 velocity so as to justify more emphasis being given to other monetary aggregates:

Despite widespread financial innovations * * * the basic underlying demand for money in the economy continues to be satisfied by the narrow class of currency and deposits which comprise M1.

Chairman Voleker added additional perspective to last year's recession:

* * * we are seeing the culmination of a much longer period of unsatisfactory economic performance extending well back into the 1970's—performance marked by poor productivity, growing unemployment, much higher interest rates, and pressures on the real earnings of the average citizen and on the real profits of our businesses.

Interest rates

Even though 1981 witnessed continuing progress in the fight against inflation and even though the economy slipped into a recession, interest rates did not decline steadily over the course of the year. Mr. Sumichrast told the Committee how high interest rates have:

* * * resulted in the decimation of housing—with the longest post war recession, the lowest production year, drastically reduced sales and unparalleled bankruptcies.

As already noted, both Secretary Sprinkel and Mr. Jordan criticized the extent of month-to-month volatility in money growth during 1981. Mr. Jordan traced interest rate movements during the year directly to this monetary volatility:

Late in 1980 and early in 1981, growth of the money supply slowed sharply and interest rates also declined * * * unfortunately, there was a spike upwards in money growth in March and April * * * that unsettled the financial markets and was accompanied by renewed upward pressure on market interest rates. By mid-year money growth had returned to a slower and less inflationary rate and interest rates began declining once again. From their peaks in the summer until late fall, short-term interest rates declined about 7 percentage points. * * *

Unfortunately, however, another period of accelerated monetary growth occurred and both short- and long-term interest rates came under strong upward pressure in December and January.

It has been noted above that the Federal Reserve Report explained the differential growth rates of the different monetary aggregates largely in terms of the relationship between interest rates and the demand for the various components of each of the different aggregates (i.e. money market funds vs. cash). Thus the Report emphasized the impact of interest rates on growth in the aggregates. This contrasts with the emphasis given by Mr. Jordan to the impact of variations in the growth of the aggregates on interest rates.

Likewise, whereas Mr. Jordan blamed fluctuations in interest rates during 1981 largely on fluctuations in money growth, the Federal Reserve Report argued that efforts to "severely limit" deviations in the growth of the monetary aggregates from their longer-run growth paths would require acceptance of much more variable short-term interest rates.

Subsequent to his appearance on February 11, Chairman Volcker sent the Committee additional information on international comparisons of monetary volatility. His point was that the:

* * * U.S. monetary aggregates rank at or near the top of the league in terms of low variability. * * *

The monthly results show that U.S. M1-B (shift adjusted) showed a narrower range of fluctuation in 1980 and 1981 than did the most nearly comparable aggregate in any other country except Italy. In the quarterly results * * * only France and Germany had a range in 1981 approximating that in the United States. In 1980, France and Italy had a much narrower range of quarterly fluctuation in M1 growth, while the range in most of the other countries, with the significant exception of Switzerland, was close to that in the United States.

* * * Italy, the one country that does "better" than the United States * * * has had one of the highest rates of growth of M1 * * * and one of the highest rates of inflation in recent years.

In this regard, Secretary Sprinkel commented that:

Following years of volatile but ever-accelerating money growth, the financial markets are now very cautious of large changes in money, even on a weekly basis. * * *

The problem is not that these very short term variations (in money growth) per se have fundamental effects on economic activity. Instead, their importance stems from the environment in which they occur. As shown by the experience in several foreign economies, variations in money growth can be absorbed with little disruption, once a basic noninflationary trend of monetary expansion is firmly established. Low inflation countries, such as Germany, Japan and Switzerland, have had smoothly declining monetary trends in recent years, even as they have experienced substantial short-term monetary variability.

Chairman Volcker took cognizance of this problem of credibility when he stated:

* * * the effort to restore stability will be more difficult to the extent policies feed skepticism and uncertainty about

whether the effort will be sustained—a skepticism rooted in past failures to “carry through.”

Mr. McKinney disagreed with Mr. Jordan's implicit blaming of the Federal Reserve's having let money-supply growth surge after October for the extent of the rise in interest rates late last year. According to Mr. McKinney:

* * * the Federal Reserve took the appropriate course of moderation (when the money supply started to grow quickly). Instead of slamming on the credit brakes and forcing interest rates to much higher levels, it (the Fed) chose to move gradually * * *

The result (of very aggressive tightening) would have been more severe disruptions in financial markets * * * (and a) very sharp rise in rates to levels well above (those actually reached).

Prospective Federal deficits also were blamed for the persistence of high interest rates in 1981. Chairman Volcker spoke of:

* * * a budgetary situation that has no parallel, in my memory anyway, in history * * * we have a situation where if one makes the assumption of a healthy, continuing recovery, with the (favorable) impact that that has on revenues, you have a widening deficit year after year beginning at a high level.

Chairman Garn noted that prospective budget deficits are the direct responsibility of Congress:

We hear all the talk about the President's budget right now. I would remind everybody that a President can recommend a budget, he can plead, he can yell, scream, shout, threaten. He can veto. But he cannot spend one dime not appropriated by the Congress of the United States.

CONCLUSIONS

Pursuant to the requirement in the Full Employment and Balanced Growth Act for a report to the Senate by the Committee on Banking, Housing, and Urban Affairs stating its “views and recommendations” regarding the Federal Reserve's Monetary Policy Report, the Committee finds:

(1) As illustrated by drops in all the indices of inflation during 1981, significant progress was made last year toward bringing inflation under control. However, the U.S. economy slipped into a painful recession when the inflationary momentum built up by fifteen years of steady increases in the underlying trend of money growth, was confronted by the rapid deceleration of money growth early last year. The rapid reacceleration of money growth after October of last year together with the prospect of continuing large Federal budget deficits caused interest rates to reverse their declines earlier in the year and climb even in the face of slowing inflation and recession.

(2) A 4 to 5 percent growth in M1 from 1981's fourth quarter through 1982—if significant fluctuations in the growth rate over the

course of the year are avoided—should be expected to be compatible with continued diminution of inflationary pressures, lower interest rates and a healthy economic expansion this year. While such growth in M1 would not constitute a further slowing from 1981's growth rate, the modest reduction announced by the Federal Reserve in the 1982 target growth range for M1 is an appropriate signal of the continuing long-term commitment to reducing the underlying trend of money growth.

(3) It would be a serious mistake to attempt to accelerate money growth during 1982 above the target ranges announced by the Federal Reserve in an attempt to make up for the shortfall in M1-B growth last year.

Avoiding fears within financial markets that the Federal Reserve is abandoning its commitment to a long-term slowing of the underlying trend of money growth is critical to reducing inflation and interest rates. An acceleration of money growth during 1982 beyond the announced target rates would lead to a renewal of such fears.

(4) In its First Monetary Policy Report for 1981, the Committee "applauded" the Board of Governors for its continuing evaluation of alternative techniques for implementing policy designed to improve shortrun monetary control * * *. In light of continuing recommendations that the Federal Reserve should eliminate lagged reserve requirements and tie the discount rate to a market interest rate, the Committee urges the Federal Reserve to continue to consider these and other potential improvements in its monetary policy tools.

The Committee also urges the Federal Reserve to pursue consideration of proposals for changing the current practice of releasing weekly seasonally-adjusted M-1 money supply estimates so as to ease the market fluctuations to meaningless announcements of changes in the aggregate.

(5) In its Second Monetary Policy Report for 1981, the Committee recommended that the Federal Reserve consider implementing monetary policy by focusing on control of bank reserves or the monetary base instead of on the monetary aggregates currently used as control variables. The justifications given for this recommendation were that: such a change and (2) it would enable analysts to "better understand (1) "the evaluation of monetary policy" would be "simplified" by such a change and (2) it would enable analysts to "better understand how open market operations are adjusted to allow for developments such as NOW-account and money-market-fund growth.

The Committee finds further justification for considering this change in Secretary Sprinkel's concern that current procedures lead to increased short-term volatility as the Federal Reserve responds to "random and self-correcting" fluctuations in the money supply.

ADDITIONAL VIEWS OF MESSRS. RIEGLE, SASSER, SARBANES, CRANSTON, AND DIXON

We find:

1. The Federal Reserve Board undershot its monetary growth target for M-1B in 1981. M-1B is the most closely watched and important indicator of monetary policy. The target range for M-1B adjusted in 1981 was set by the Board of Governors at a very tight 3.5 percent to 6 percent. The actual growth of M-1B was 2.3 percent.

M-1B includes currency held by the public plus demand deposits at commercial banks, travelers checks, and other checkable deposits at all depository institutions, including NOW (Negotiable Order of Withdrawal) accounts, accounts subject to automatic transfer services, and demand deposits at thrift institutions. Basically, therefore, M-1B includes all checking and transaction accounts. The Federal Reserve Board was beneath its target range for this vital aggregate between 34 percent and 62 percent. Such stringency in this key monetary aggregate resulted for all practical purposes in a lack of adequate credit at reasonable rates.

2. The Federal Reserve Board was also below the Administration's own suggested targets for growth in the monetary aggregates. In its *Economic Recovery Program* issued February 18, 1981, the Administration set out a moderate course for monetary policy from 1981 through 1986, which it believed to be consistent with its target projections for economic growth, a declining federal deficit and a balanced budget by 1984. To be consistent with these targets, the Administration suggested that the growth rate of the monetary aggregates be reduced slowly from 1980 levels to one-half of those levels in 1986. Since M-1B grew 7.3 percent in 1980, the Administration's original objective implied a reduction in annual money growth rates of about 3.6 percentage points over six years, or a progressive reduction of about 0.6 percentage points in money growth in each year. This was the assumption that underlay the Administration's original economic forecasts, and its fulfillment would have meant money growth averaging above 6 percent annually in 1981. Instead, money growth in 1981 was only 2.3 percent, well below the bottom of the Federal Reserve Board's target range, and about one-third of what the Administration originally considered desirable. Both the Administration in its fiscal policies, and the Federal Reserve in its monetary policy, missed their targets by a wide margin.

3. This sharply reduced money growth combined with the projected deficits resulting from the Administration's economic policies is a major cause of our current high interest rates, and the deep recession with resulting high unemployment and business bankruptcies.

4. The Federal Reserve Board's excessively tight monetary policy in 1981 contributed directly to high interest rates, increased unemployment, an unprecedented number of business failures, declining productivity, and plummeting housing starts and auto sales. More specifically:

Treasury bills, notes and bonds reached the following peaks in 1981, each the highest rate on record:

Offering	Yield (percent)	Date
13-week bills.....	16.750	May 22.
26-week bills.....	15.854	Aug. 24.
52-week bills.....	15.056	Sept. 3.
2-yr notes.....	16.26	Aug. 20.
4-yr notes.....	15.91	Sept. 23.
7-yr notes.....	15.40	Oct. 7.
10-yr notes.....	14.98	Aug. 5.
20-yr, 1-mo bonds.....	15.78	Sept. 30.
30-yr bonds.....	14.10	Nov. 5.

The average municipal bond rate increased to 13.44 percent on January 15, 1982, the highest rate on record.

The number of persons unemployed increased to a seasonally adjusted 9,575,000 in February of 1982, the highest number since 1939.

Business failures increased to 17,043 in 1981, 33 short of being the highest number since 1933. In the current year business failures are 52 percent above last year's levels.

Productivity in the non-farm sector declined at a seasonally adjusted annual rate of 6.8 percent in the fourth quarter of 1981, the sharpest decline on record.

New private housing starts dropped to 1,085,300 in 1981, the lowest number on record.

Domestic auto production dropped to 6,252,329 in 1981, the lowest level since 1961.

Excessively tight monetary policy has also caused a sharp decline in net exports and has crippled the savings and loan industry.

Net exports have declined sharply. GNP measured in 1972 prices declined \$18 billion in 1981. Fully two-thirds of that decline—\$12 billion—was attributable to a fall in net exports. This happened because high interest rates attract foreign capital and cause the price of the dollar to rise in international currency markets. The resulting overvaluation of the dollar increases the attractiveness of imports, makes it difficult to sell exports, and transfers jobs from the U.S. to foreign currencies.

Savings and loan associations are currently in their worst state since the bleakest days of the Great Depression. They suffer as a result of their having to pay higher interest rates to attract funds than they receive on their long-term outstanding mortgages. The Federal Home Loan Bank Board recently released statistics showing that over 90 percent of the associations in the country are losing money, and in 1981, return on assets for the S&L industry translated into a negative .75 percent.

5. The "Full Employment and Balanced Growth Act of 1978" not only requires the Board of Governors of the Federal Reserve System to transmit its report to Congress, and for us to submit our report, but it also declares as its purpose "an effective policy to promote full employment and production, increased real income, balanced growth, * * * adequate productivity growth, proper attention to national priorities, achievement of an improved trade balance, * * * reasonable price stability," as well as a "balanced Federal budget."

By their actions the Federal Reserve Board and the Administration have made enormous budget deficits inevitable now and in the future. The projected budget deficits under the Administration's proposal, according to their own estimates, amount to \$100.5 billion in FY82, \$101.9 billion in FY83, \$93.8 billion in FY84, and \$81.8 billion in FY85. The Congressional Budget Office projects these deficits at \$119.3 billion in FY82, \$182.0 billion in FY83, \$216.0 billion in FY84, and \$232.5 billion in FY85.

6. The seriousness of the present budget crisis is being rendered infinitely more complex and serious because of the recession and the high interest rates. When the unemployment rate increases one percentage point, the Federal budget deficit automatically rises \$25-30 billion because of depressed tax receipts and added unemployment compensation and other transfer expenditures. In the fourth quarter of 1981 the deficit reached an annual rate of \$99.5 billion. Much of that was attributable to the recession.

Furthermore, the high interest rates add to the cost of financing the debt. Since this means even more debt must be financed, there is therefore the danger of an uncontrollable circle that could lead to a steady escalation of interest rates and deficits in the future.

7. The Majority Report of the Committee finds that "significant progress was made last year toward bringing inflation under control", and suggests that tight monetary policy was a significant contributing factor.

Robert Solow, a professor of economics at the Massachusetts Institute of Technology and James Tobin, recipient of the 1981 Nobel Prize in economics, in a recent co-authored article state that "some part of the reduction in the inflation rate is just dumb luck." They point out that "Crops have been good and so food prices have actually fallen in the past year * * * [a]nd recession around the world, combined with divisions within OPEC, has kept the price of oil from rising." They go on to state "The rest of the improvement in the inflation rate is a result of the recession." The fact of the matter is that whatever progress has been made on inflation has been made by virtue of exclusive reliance on Federal Reserve Board monetary policy, fully supported by the Administration, to the detriment of a number of our most vital industries including housing, autos, agriculture and small business plus a healthy degree of luck.

8. In the midst of this deep recession, which is now worldwide, and continuously declining economic indicators, the Federal Reserve Board recommends further lowering of the monetary target range. The 1982 target range for M-1 has been set at 2.5 percent to 5.5 percent. This compares with a target range of 3.5 percent to 6 percent in 1981 for M-1B adjusted, the equivalent measure in use at that time. This policy may continue to keep inflation down but only at the expense of real economic growth.

We conclude:

1. The Federal Reserve Board monetary policy does not operate in a vacuum. It has a crucial effect on interest rates and, consequently, on economic activity in the marketplace. Because of the importance of its policies to economic activity, the Federal Reserve Board needs to be especially sensitive in the conduct of monetary policy to the credit needs of the whole economy, including housing, autos, small business

and agriculture. The Federal Reserve Board has not been as sensitive to the needs of the whole economy as it should be.

2. The "Full Employment and Balanced Growth Act of 1978" provides in Section 2 for "improved coordination among the President, the Congress, and the Board of Governors of the Federal Reserve System" in setting and attaining economic objectives and goals. Despite this clear intent, fiscal and monetary policies are on a collision course in the years ahead with tight monetary policy clashing with easy fiscal policy. Burdensome high interest rates, or continued recession in economic activity, or both, will be the result of the continuation of these clashing policies. The coordination of economic policy which is called for in the law is being ignored, adding to the already precarious condition of our national economy.

3. The Federal Reserve Board's monetary growth targets for 1982, in light of the depressed state of large sectors of the economy and unemployment, are too restrictive to simultaneously allow any substantial relief from high interest rates and make room for stable economic growth.

4. We believe that unless the mix of fiscal and monetary policies are changed, recovery from the current recession will be choked by high interest rates. Rates will be high because corporate and individual demands for credit in a recovery will have to compete with hefty federal deficit financing needs at the same time the Federal Reserve Board is reducing monetary growth.

5. We believe that the Federal Reserve Board should adjust the monetary targets in effect for 1982 so as to permit increased economic activity throughout all sectors of the economy including housing, autos, small business, and agriculture as well as to improve the conditions for long-term business financing and the financing of municipal services. Given current unemployment levels and the slack in the economy, there is great leeway for the Federal Reserve Board to reduce interest rates while not exacerbating inflation.

6. We believe that our economy has become over-sensitive to changes in the growth of the money supply. There are several reasons why this has happened. First, since October 1979 the Federal Reserve Board has had an announced policy of controlling the money supply and letting interest rates be determined by the marketplace. Second, the Administration has strongly endorsed the monetarist view of the world—constraining the growth of the money supply will solve all of our economic problems. Third, the publication of money supply data each week focuses attention by both the financial markets and the media on the money supply. We do not believe that the money supply is the most important economic variable. We believe the Federal Reserve Board should modify its approach to policy and include in it a clear recognition of interest rates, both real and nominal. With inflation of 7 to 8 percent and short-term interest rates of 14 percent we suffer from real interest rates of 6 to 7 percent which we believe is a situation which is unacceptable.

7. We believe that both the Board of Governors of the Federal Reserve Board and the Administration should be more sensitive to the human suffering that the current recession is causing to millions of Americans and should abide by Section 5(b) of the "Full Employment and Balanced Growth Act of 1978" which states explicitly "In

choosing means to achieve the goal for the reduction of unemployment and choosing means to achieve the goal of reasonable price stability, those means which are mutually reinforcing shall be used to the extent possible."

DONALD W. RIEGLE, Jr.

JIM SASSER.

PAUL SARBANES.

ALAN CRANSTON.

ALAN J. DIXON.

ADDITIONAL VIEWS OF MR. PROXMIRE

I agree with the Committee's major conclusion that the target ranges for growth in the monetary and credit aggregates set by the Federal Reserve Board for 1982 are appropriate and signal to the Congress and the financial markets a continuation of their commitment to gradually reduce the trend of monetary and credit growth to non-inflationary levels.

However, there are several important issues that the Committee's report either avoids or does not confront head on that require additional comment.

First, by any standard interest rates are too high. This is true by historic comparison, especially with regard to past recessionary periods. Some action is needed to get interest rates down if the recession is to be ended and investment and productivity rejuvenated. The longer high interest rates persist the larger the damage of serious dangers to the economy. The effects of high interest rates are unevenly distributed in our economy and several important sectors have had to bear a disproportionate burden—especially small business, housing, and agriculture to name only a few.

Is the Federal Reserve Board to blame? The Fed has been steadfast in its commitment over the past two and one-half years to reducing inflation. Unfortunately, the Fed continues to be the only anti-inflation game in this town. The primary problem is the set of economic policies recommended by the President and adopted by the Congress last year. Those policies have left us with the prospects of the highest deficits over the next several years in our nation's history. If no action is taken to reduce them the cumulative deficits over the next several years will equal our total outstanding indebtedness. This is both alarming and untenable. The high deficits assure us of continued high interest rates because the Federal government with its huge market power will get the credit it needs and this will deprive the private sectors of the economy of the credit they need. Therefore, our first priority should be to reduce the deficits and reduce them sharply.

There is a basic conflict in our current economic program: you cannot have massive tax cuts, extremely large increases in defense outlays, and moderate growth in money and credit all at the same time without getting high interest rates and slow economic growth. Our mixture of policies—tight monetary and loose fiscal—assures little or no growth in private investment (which is now observable), a slack economy (which is now observable), and high interest rates (which are now observable).

Monetary policy is not solely to blame for our problems. Relative to our current fiscal policy monetary policy is tight and has contributed to high interest rates. We need to tighten up fiscal policy—to reduce spending and cut the deficits for future years. This will

automatically result in a relatively less restrictive monetary policy. This means that the Administration and the Congress must bear the blame for high interest rates and take action. The deficits must be reduced and the budget brought into balance as quickly as possible.

Second, monetary policy is now the only anti-inflation game in town. The Committee's report fails to emphasize this and fails to recommend that Congress and the Administration develop anti-inflationary programs to help the Federal Reserve. History has taught us that the Fed cannot do it alone. If the gains that have been made in reducing inflation are to be maintained we need a program for restraining inflation as we come out of the recession.

Our progress in reducing inflation over the past 12 months has been the product of the Fed's commitment to its long-term objectives and a lot of luck. Most recently we have had a large external anti-inflationary shock in the form of falling oil prices due to a world-wide glut. But how long will that last? We have also been fortunate to have not had extreme shocks in agricultural prices. And, falling housing prices have helped slow the CPI because of the disproportionate weight housing is given in that index. But again, what will happen once this ends?

We have built up a huge excess demand for housing, autos, and capital that is bound to have effects on credit demands and inflation as we come out of the recession. Further, although we have made some progress in slowing unit labor costs the underlying rate of inflation at 7 or 8 percent is too high, especially with little or no help from productivity growth.

The Administration and the Congress have a responsibility to develop an anti-inflation program now, before we start out of this recession.

Third, too much emphasis is now being placed on short-run monetary policy. All economists agree that money growth over the long-run has important effects on the economy and inflation. That is precisely the reason why the Congress, in the Humphrey-Hawkins Act passed in 1978, instructed the Federal Reserve to report their policy targets on an annual basis. In fact, it should be recalled that some members of Congress wanted multi-year targets to be announced by the Fed consistent with the multi-year objectives for GNP, employment and prices that the President must specify.

The focus on monetary policy has, unfortunately, gone the other way. We have created a situation where the financial markets, the press, and even laymen watch the Friday afternoon release of M-1 data as if it has some magical meaning. It does not, and is often very misleading. It is impossible and probably not desirable for the Fed to closely control money growth on a week-to-week or even a month-to-month basis. The emphasis that the monetarists have placed on short term control of M-1 is now detrimental, not helpful.

In this respect, the Committee's report has taken a view that is too monetarist. There is no sound economic evidence that growth in the money supply in the very short-run must be closely and smoothly controlled. The economy does not grow smoothly, why should money? Moreover, the Federal Reserve does not have the tools needed to closely control money growth. Why should they? What would it take? Tight monetary control would perhaps be possible if the Fed could dictate to

financial institutions how they should manage their assets and liabilities. But, Congress has not given the Fed that authority for the simple reason that the marketplace can make those decisions better than policymakers. Deregulated financial markets and close control of the money supply in the very short-term are incompatible.

Finally, the Committee's report recommends that the Federal Reserve change its operating procedures. I am confident that the Fed is constantly reviewing these issues. I think, however, that some of the recommendations need to be sharpened.

Lagged Reserve Accounting.—In my view this is not a major issue in and of itself. But, it does have implications for other changes that would be desirable. Shifting to a system of contemporaneous reserve accounting now that all depository institutions are subject to reserve requirements under the Monetary Control Act could be very costly. Indeed, for many of those institutions contemporaneous accounting might be extremely difficult. Moreover, having all of those institutions meeting reserve requirements in a contemporaneous reserve accounting system on the same day would increase the volatility of short-term interest rates. The Fed should consider moving to a more contemporaneous reserve accounting system than we now have if it would be helpful for achieving their policies. But, it need not be exactly contemporaneous, some flexibility would be helpful. Also, the Fed should consider the recommendations that have been made to stagger the reserve accounting period so that not all of our 40,000 depository institutions have to scramble to meet their requirements at the same time. This could be done simply by having one set of institutions meet their requirements one week and another set in the following week on a staggered yet as nearly as possible contemporaneous basis.

Discount Rate Setting.—The Committee has long recommended that the Fed change the discount rate setting mechanism to one where the rate moves with market rates and is set at a penalty level in most circumstances. The current rate setting has no economic rationale, it has to do with the relationship between the Fed Board and the Reserve Banks. It also has to do somewhat with the current system of lagged reserve accounting. Changing the reserve accounting procedures would permit a floating discount rate which is certainly justifiable on economic grounds.

Weekly Monetary Statistics.—The financial markets have become addicted to the weekly release of money supply data as if it had some significant economic meaning. It does not. Those data are erratic and subject to wide swings and seasonal adjustment problems. The Fed ought to release the money supply data only once a month as is done now with all of the most important economic data—employment, unemployment, prices, capacity utilization, etc. This would result in less churning in the marketplace and less volatility of short term interest rates which now permeates to every corner of our economy.

October 1979 Operating Procedures.—In October 1979 the Fed indicated that it was henceforth going to focus attention on money supply growth and let interest rate fluctuate in a wide range—in fact, they would have the market set rates. This was a useful change for the Fed at that time since they no longer had to shoulder the blame for high and volatile interest rates. But, we must learn from experience: interest rates have important effects on the economy and money market condi-

tions do matter. We now have real interest rates that are far beyond the historic average in this country. This makes nominal interest rate way out of line with current inflation. Expectations more than economic fundamentals are now playing too large a role in the setting of interest rates. The Fed has some responsibility for this. It ought to consider whether some mixture of money supply growth and money market conditions is a better guide to policy than the current format established in October 1979.

WILLIAM PROXMIRE.

